Guidelines for Classification and Valuation of Investments – Clarifications/ modifications

REF. DBS.FID No. C-6 /01.02.00/2001-02

16 October 2001

To the CEOs of the all-India Term Lending and Refinancing Institutions

Dear Sir,

Guidelines for Classification and Valuation of Investments – Clarifications/ modifications

Please refer to our Circular DBS.FID.No. C-9 /01.02.00./2000-01 dated November 9, 2000 on the captioned subject. Certain suggestions / queries have since been received from some of the financial institutions on some of the aspects of the captioned Guidelines. The issues raised have been examined and it has been decided to issue clarifications and where necessary, modifications to the Guidelines, as detailed in the Annexure.

2. Please acknowledge receipt.

Yours faithfully,

(K. C. Bandyopadhyay)
Chief General Manager

Guidelines for Classification and Valuation of Investments – Clarifications / M

S. No.	Present norms of RBI	Suggestion / query	Clarification / modification
1.	**Definition of Joint Ventures** The Joint Ventures have been defined as one in which the FI, along with its subsidiaries, holds more than 25% of the equity. Our instructions also permit unlimited inclusion of **all equity holdings** of FIs in its subsidiaries joint ventures as defined above in the "Held to Maturity" category, even though equity shares, by definition, have no maturity.	FIs could acquire equity in the borrower companies in excess of 25% also through **conversion** of loans, **venture capital** assistance, etc., but as per the prescribed definition, such cases would be deemed to be joint ventures and would necessarily have to be placed in the HTM category. It is therefore, suggested that **such investments** should **not be classified in the HTM category** but may be included in one of the **six sub-categories** of the AFS or HFT classification as per the nature of the instrument	A Joint Venture would be an entity in which a FI (along with the holdings, if any, by its subsidiary) holds more than 25% of equity capital **pursuant to a Joint Venture agreement** duly entered into between / amongst the FI and the joint venture partner(s) for furtherance of a commercial objective. Besides, the companies floated by the FIs and in which the FI (along with the holdings, if any, by its subsidiaries) holds more than 25 per cent of the equity share capital, would also be classified as a Joint Venture. Only such equity holdings, as also the equity held in subsidiaries, should be placed in the HTM category – and not where a FI, along with its subsidiaries, acquires equity in excess of 25% on account of conversion of loan, venture capital assistance, etc.
2.	**Treatment of preference shares** At present, the preference shares are not explicitly permitted to be included in the HTM category.	The preference shares, if held in the HTM category, should also be excluded from the prescribed ceiling of 25% (of total investments) on HTM category investments on par with debentures / bonds deemed to be in the nature of advance.	The preference shares, other than convertible preference shares, on account of their definite maturity period, may be included in the HTM category, regardless of their period of maturity, subject to the following. The preference shares, other than convertible preference shares, acquired as a part of project financing and meeting the extant criteria for treating the bonds and debentures as 'in the nature of advance', should be treated in the nature of advance.

			Such preference shares would also not be counted for the purpose of the ceiling of 25% on the investments in the HTM category. Such preference shares should be valued by notionally extending to them the asset-classification of the outstanding loans of the issuing company and provision for depreciation in the value of preference shares made accordingly. In case the said loans are in the standard category, provision as per norms applicable to the standard loan assets would be required for the depreciation in the value of these shares. In case the loans are in the doubtful category, the preference shares held should be treated as an unsecured facility and fully provided for. All other preference shares, if kept in the HTM category, should be reckoned within the ceiling of 25% for the investments in the HTM category. Such shares should be valued at the acquisition cost unless acquired at a premium, in which case they should be valued at the amortised cost. Any diminution, other than temporary, in value of these shares should be determined and provided for each investment individually and should not be set off against appreciation in other preference shares.
3.	**Tenor of bonds/ debentures deemed to be in the nature of advance** The extant norms require debentures / bonds issued as part of project finance with a tenor of **three years and above** or those issued as part of working capital finance with tenor of **less than one year,** through private placement with FI's stake of 10% or more in the issue, to be treated in the nature of advance. Such	The borrowers issue privately placed debentures for meeting **project cost**, **working capital** needs, as part of **debt restructuring.** Often, debentures of **more than one-year** maturity are privately placed for meeting **long term working capital** requirements. Such debentures are **"normally"** in the nature of credit and are held by the FIs till maturity. Hence, these should be treated as advance **irrespective** of their	It is difficult to accept the suggestion since any instrument issued by a company and placed privately, say, CPs, CDs, could be argued to be in the nature of credit since all such instruments are fixed charge bearing liabilities of the issuer. Hence, the argument could as well be extended to several other instruments too and not only to the privately placed debentures and bonds. As such, the suggestion is not acceptable.

	bonds / debentures, though included in the HTM category, are not counted for the purpose of 25% ceiling on the HTM category of investments.	tenor (maturity) and purpose. The RBI guidelines should not differentiate between project finance debentures and working capital finance debentures. All long term debentures with maturity more than 3 years, should be deemed to be in the nature of advance and included in the HTM category, since these are primarily in the nature of loans and are subject to the same level of due diligence, appraisal, documentation, etc., as a normal loan.	Reckoning the predominantly long- term nature of loan assets of the FIs, it has been decided to **modify the guidelines** to remove the exemption available at present from the 25% ceiling for the HTM category of investments in respect of the debentures acquired by FIs as part of working capital finance with maturity of less than one year. Thus, only the debentures / bonds with **tenor of three years and more**, acquired through private placement, with the FI holding at least 10% stake in the issue, would be deemed to be in the nature of advance and could be included in the HTM category and excluded for the purpose of 25% ceiling on the HTM category. All debentures/ bonds of less than three-year tenor, therefore, should be placed in the AFS or HFT category; such debentures, if kept in the HTM category, should be reckoned within the 25% ceiling.
4.	**Frequency of inter-category transfer of investments**: At present, the shifting among categories is permitted only once a year, normally at the beginning of the accounting year, with the approval of the Board of the FI.	Shifting of investments from / to HTM category be permitted twice in a year instead of once a year as prescribed at present.	The **suggestion is not acceptable** as it would lead to arbitraging in the regulatory provisioning requirement.
5-a	**Eligible investments for HTM Category**: At present, only debt securities, which have a definite maturity, are intended to be included in the HTM category. Besides, equity investments in subsidiaries and joint ventures are permitted without any ceiling in the HTM category.	It is presumed that the equity shares of companies other than joint venture/ subsidiaries and units of mutual and other funds can also be categorised under HTM category.	In keeping with the international norms, only debt securities are to be classified under the HTM category. The only **exceptions permitted** are the equity held in **the subsidiaries and joint ventures, apart from preference shares now permitted as at item 2 above.** As such, the question of including equity of other companies and the units of open-ended schemes of mutual funds in the HTM category does not arise.
5-b	**Valuation of equity in HTM**		

	category The other-than-temporary diminution in the value of equity held in subsidiaries / joint ventures, which are included in the HTM category, is required to be determined and provided for each investment, **individually.**	Valuation of equity and of units of open ended unit schemes need not be done at amortised cost, as these have no maturity.	In view of our comments at 5(a) above, the question becomes redundant. It is, however, clarified that the equity holdings in the nature of advance should be **compulsorily placed in the 'Available For Sale' category**. Such equity should be valued by notionally extending to it the asset-classification of the outstanding loans of the issuing company and provision for depreciation in the value of equity made accordingly. In case the said loans are in the standard category, provision as applicable to the standard loan assets would be required for the depreciation in the equity value but in case the loans are in the doubtful category, the equity held should be treated as an unsecured facility and fully provided for.
6.	**Period of pendency of dues:** Where interest/ principal is in arrears on securities included in any of the three categories, the FI should not reckon income on securities and also provide for depreciation in the value of investment.	It is presumed that the definition of arrears of interest / principal in respect of securities would be as per the extant prudential norms viz., 2 and 4 quarters for interest and principal respectively.	The period of pendency of dues should be reckoned as per the extant prudential norms. With effect from the year ending 31 March 2002, the overdue period for the principal amount has been reduced to 180 days only, vide our Circular no. C-23 dated 24 April 2001. This change would also apply to the arrears of principal in respect of securities.
7.	**Valuation of preference shares:** The preference shares should be valued on YTM basis, with the YTM arrived at with appropriate mark up over the YTM rates for Central Government securities, as notified by FIMMDA/ PDAI. However, our instructions are silent regarding the impact of the tax-free nature of the dividend on the preference shares, in the hands of the holder of these shares..	YTM rates for valuation of preference shares should be lower than the YTM for the debt instruments since preference dividend is tax-free in the hands of the investors (FIs). Hence, YTM used for preference share valuation should be discounted by the marginal tax rate of the FI.	It is clarified that the guidelines framed by FIMMDA for valuation of tax-free bonds should be followed for valuation of unquoted preference shares, other than those kept in the HTM category, as per the following procedure: a) Gross up the nominal (tax-free) dividend rate on the preference shares by the marginal income tax rate of the FI – which might change from year-to-year – to get the cum-tax dividend rate ;

			b) Find the YTM of the GoI security of the equal residual maturity from the rates declared by FIMMDA; c) Add the applicable credit spread / risk premium (as per the rating of the preference shares) specified by FIMMDA for that risk category, to the YTM of the GoI security arrived at step (b) above. d) In case of **unrated preference shares**, the credit spread / risk premium to be added to the YTM of the GoI security arrived at (b) above, should be determined in the following manner: (i) In case the company issuing unrated preference shares has any other rated instruments which are outstanding, then a rating one full-notch below that rating should be arrived at. (For instance, for a 'AAA' rating, only 'AA' rating should be reckoned.). In case more than one rated instrument issued by the company is outstanding, then the rating of that instrument which has been assigned the rating most recently, should be reckoned. The risk spread corresponding to such rating, as announced by FIMMDA, would be the spread to be added to the YTM of the GoI security. (ii) In case, no other instrument of the company issuing the preference shares has been rated and is outstanding, then a credit spread not less than the spread applicable to a bond of minimum investment grade, i.e., a 'BBB' rated bond, would be the spread to be added to the YTM of the GoI security. e) Compare the grossed up/ cum-tax

			dividend rate of step (a) above with the risk-adjusted YTM of the preference share arrived at step (c) or (d) above and use the **higher** of the two rates as the effective YTM for valuation of the preference share.
8.	**<u>Ceiling on YTM valuation of preference shares:</u>** The norms do not permit the valuation of preference shares above their redemption value, even if the YTM valuation happens to be above the redemption value.	The valuation of preference shares should be strictly on YTM basis even if the YTM valuation results in a value higher then the redemption value.	Reckoning that the valuation methodology prescribed by us for the unquoted preference shares is quite refined, the restriction of NOT valuing the preference shares above their redemption value stands withdrawn. Accordingly, the unquoted preference shares should be valued strictly on YTM basis even if such valuation results in a value higher then the redemption value.
9(a)	**<u>Definition of "quoted" shares:</u>** Our guidelines are silent regarding the definition of "unquoted" equity shares.	Clarification is sought as to how old quotation could be considered to be "current" quotations for deciding whether the share is quoted.	It is clarified that for an equity share, if the latest market quotation available, as at the date of valuation, is **more than 30 day-old,** it may be considered to be an **unquoted investment** and valued at break up value, as prescribed. Furthermore, the market price for valuation of quoted equity shares should not be derived from a solitary trade for a small-volume transaction but should be the price observed for a reasonable volume of transaction between two independent parties in an arms-length relationship. The 'thinly traded shares' should be identified and valued as detailed below. **<u>Thinly traded equity shares / equity related securities'(such as convertible debentures, equity warrants, etc):</u>** The 'thinly traded equity / equity related securities' would be those for which the trading in a month is for less than Rs. 5 lakh or the total trading volume is less than 50,000 shares.

			Where the stock exchange concerned identifies such securities as per the foregoing criteria and publishes / provides such information for the preceding calendar month alongwith the daily quotations, such latest quotations should be used for valuation of such shares. In case the equity is listed on a stock exchange which does not provide such information, the FIs may undertake their own analysis as per above criteria to determine whether the share is a thinly traded one. If so, the latest available quotation should be used for valuation.
9(b)	**The age of the "latest" balance sheet:** The unquoted equity shares or where current quotations are not available, are required to be valued at "break up" value derived from the company's latest balance sheet. Such balance sheet should NOT be older than one year from the date of valuation. In case, the latest balance sheet is not available, the shares should be valued at Re.1/- per company.	The break up value of unlisted companies may be determined as per the latest balance sheet which should not be more than 21 month old as against the present prescription of not more than one year prior to the date of valuation. The suggestion is relevant for the companies which close their annual accounts on dates other than 31 March.	In view of the genuine operational problems, it has been decided to modify the guidelines to provide that in respect of companies which close their annual accounts on dates other than 31 March, the latest balance sheet used for determining the break up value **should not be older than 21 months**, as on the date of valuation, failing which, the equity shares should be valued @ Re. 1/- per company.
10.	**The ceiling of 25% on the HTM category:** Under the norms, the investments included in the HTM category should not exceed 25% of the total investments.	It has been suggested that in view of very small investment portfolio of FIs compared to the banks, 25% ceiling on HTM category, is too restrictive and does not provide scope for inclusion of long-term equity investments in the HTM category. Hence, it has been pleaded that the **equity investments** and bonds/ debentures deemed to be in the nature of advance, should be compulsorily included in the HTM category. Otherwise, the ceiling of 25% on the HTM category be raised to	As already stated above at item 5(a) above, only debt securities are to be included in the HTM category, in keeping with the international norms. The permitted exceptions are equity in subsidiaries and joint ventures and now permitted, preference shares. As such, inclusion of equity in the HTM category is not permissible, as equity has no maturity. As regards the suggestion for increasing the limit on the HTM category to 35% to maintain a level playing field with the

		35%.	banks which have only 25% ceiling, the argument is fallacious. In several other respects too (e.g., CRR, SLR, priority sector lending, etc.), FIs do not carry the same regulatory burden as banks.The suggestion is not acceptable. **<u>Computation of the 25% ceiling</u>:** For computing the ceiling of 25% for the HTM category, the following type of investments should be excluded from the total investments and 25% of the balance amount would constitute the ceiling: a) Equity held in subsidiaries / Joint Ventures; b) Bonds / debentures and preference shares meeting the prescribed criteria and treated in the nature of advance; c) Other investments (equity shares) in the nature of advance which may be held in the AFS category.